

**BEFORE THE
PUBLIC SERVICE COMMISSION OF WISCONSIN**

**Application of Milwaukee Water Works, Milwaukee
County, Wisconsin, for Authority to Increase Water
Rates**

3720-WR-107

SURREBUTTAL TESTIMONY OF LOIS J. HUBERT

August 5, 2010

1 **Q. Please state your name.**

2 A. My name is Lois J. Hubert.

3 **Q. Did you also provide supplemental direct testimony in this docket?**

4 A. Yes.

5 **Q. What is the purpose of your surrebuttal testimony?**

6 A. The purpose of my testimony is to respond to supplemental rebuttal testimony from Eric
7 Rothstein given on behalf of the intervening wholesale customers, Thomas Schrader
8 given on behalf of himself as a concerned citizen who is a water customer of one of the
9 wholesale customers, James Wojcehowicz given on behalf of the City of Wauwatosa, and
10 Michael Rau given on behalf of the City of Mequon and Village of Brown Deer.
11 However, I will first provide some background and highlight some items for the record
12 which relate to the return on rate base.

13 **Q. Please begin.**

14 A. Based on financial markets and the Commission model, Commission staff estimated a
15 reasonable return on rate base of 6.50 percent for Milwaukee Water Works (MWW).
16 Commission staff historically does not support returns on rate base unless they provide at

1 minimum a 1.5 times interest coverage and 1.25 times cash flow to total debt service.

2 Because MWW is conservatively capitalized with over 90 percent equity, these minimum
3 coverages can be obtained with less than 1.00 percent return on rate base.

4 These two positions establish a range of 1.00 percent to 6.50 percent for the return
5 on rate base. Historically, the Commission has recognized the interrelationship between
6 the municipal utility, retail ratepayer, municipality, and city electorate/taxpayer. To the
7 extent that the municipal utility's requested return on rate base is within the allowable
8 range, in recognition of this interrelationship, the Commission has historically
9 accommodated the municipal utility's return preference. This policy recognizes Wis.
10 Stat. § 196.58(1) and the concurrent jurisdiction that the governing body of a
11 municipality has over its public utility, while preserving the Commission's own
12 jurisdiction to regulate municipally-owned public utilities under Wis. Stat. § 196.58(4)
13 and (5).

14 The Commission last set MWW's return on rate base in 2007 at 3.30 percent for
15 both wholesale customers and retail customers, pursuant to MWW's request. In 2007,
16 MWW had approximately \$34.4 million of cash reserves. (For test year 2010, MWW's
17 cash reserves are \$14.5 million.) In this case, MWW has asked for a differential between
18 returns used for wholesale customers and retail customers, with a 6.50 percent return for
19 its wholesale customers and a reduced return of 5.00 percent for its retail customers. The
20 corresponding return on municipal equity is 6.73 percent and 5.07 percent, respectively,
21 for wholesale customers and retail customers. This compares to MWW's embedded cost
22 of debt of 4.32 percent and a market yield of 4.50 percent for 30-year AAA-rated General
23 Obligation Municipal Bonds. In response, the wholesale customers have proposed a

1 return on rate base of 3.50 percent, which reflects a return on municipal equity of
2 3.41 percent. Consequently, in this docket the proposed range for consideration is
3 3.50 percent to 6.50 percent with the issue of a differential between the returns applicable
4 for retail and wholesale service.

5 In balancing the needs of the wholesale customers, retail customers, and the
6 utility, the Commission may wish to consider the following. One, the revenue impact on
7 customers is greater when the return increases from a reduced return to a market return.
8 Two, in financially tight times should the Commission require MWW to keep offering
9 rates based on below-market estimated returns? Three, customers are also affected by the
10 economic environment and look for mitigation of rate increases. Four, because of
11 MWW's low-leveraged capitalization the Commission could set a lower return while still
12 meeting the 1.5 times interest coverage threshold. Five, what impact would lower
13 coverage levels have on MWW's credit ratings or credit availability? Six, should MWW
14 earn less on its municipal equity than the cost of its debt? Seven, what are the
15 implications, if any, of the fact that retail customers tend to be ratepayers and taxpayers
16 while wholesale customers are only ratepayers? Eight, return on a municipal utility's rate
17 base should be set on the basis of what the Commission determines is in the public
18 interest, not as a counterbalance to the utility's payments in lieu of taxes.

19 **Q. Please comment on Mr. Rothstein's discussion on times interest coverage on**
20 **page SR2.98 of his testimony.**

21 A. Minimum interest coverage is a topic that needs to be approached with caution. Because
22 a minimum is required does not mean that the minimum is the proper standard. A high
23 equity capitalization may provide the opportunity for the municipal utility to offer lower

rates, but most of the wholesale customers of MWW are not following this policy. As the chart below shows, many of the suburban communities that are wholesale customers of MWW have high equity levels and approved rates of return for their retail service that are as high or higher than MWW's proposed wholesale rate of return:

Municipal Utility	Docket Number	Order Date	Municipal Equity	Return on Rate Base	Return on Municipal Equity	Times Interest Coverage
Brown Deer	780-WR-105	3/17/06	95.92%	7.00%	7.11%	38.47
Butler	860-WR-107	6/11/09	86.34%	7.00%	7.75%	22.38
Greendale	2360-WR-102	5/27/08	87.72%	5.00%	5.17%	10.77
New Berlin	4090-WR-103	5/29/09	69.25%	6.75%	7.92%	5.34
Wauwatosa	6320-WR-105	9/9/06	72.82%	6.75%	7.66%	5.75

This chart shows the rates of return the Commission approved in its most recent orders for these utilities. The last column shows the applicable coverage either included in the order or calculated with the data from the order.

Q. Please comment on Mr. Rothstein's statement on page SR2.99 that the resultant rate increase will well exceed what is required to sustain MWW.

A. The city of Milwaukee and its taxpayers have financed utility rate base assets that are being used to provide wholesale service to the wholesale customers. The Commission could focus on the return needed to sustain MWW or it could determine an appropriate return on the assets employed. Historically, the Commission has chosen to determine the appropriate return on assets employed as the method of setting the return on rate base. If the Commission focuses on a return needed to sustain MWW, benefits will accrue to the wholesale customers through lower rates at the expense of the city of Milwaukee and its taxpayers.

On the other hand, if the Commission focuses on the appropriate return on the assets employed, the return that it sets will incorporate the interests of Milwaukee taxpayers because they are the effective owners of the assets. While MWW's retail

1 ratepayers also tend to be Milwaukee taxpayers who benefit from this approach,
2 wholesale customers are not Milwaukee taxpayers and they do not garner this benefit.

3 **Q. Please discuss the application of gradualism in setting returns.**

4 A. In setting the return on equity for investor-owned energy companies, this Commission
5 has practiced gradualism; that is, it tends to incrementally move the return on equity as
6 market returns change. MWW's return on rate base is currently 3.30 percent and it
7 requested returns of 6.50 percent and 5.00 percent. This is not a gradual increase.
8 However, the 3.30 percent reflects a voluntary below market return and the decline to
9 3.30 percent was not gradual either. The authorized return on rate base granted in the
10 Commission's February 15, 2002, *Final Decision* in docket 3270-WR-104 was
11 6.50 percent. The Commission may wish to consider whether gradualism should be
12 applied under these circumstances.

13 **Q. Please address Mr. Rothstein's comments on page SR2.100 that with MWW's**
14 **atypical capital structure, the PSCW should not use its standard "capital structure**
15 **neutral" method.**

16 A. The standard principle when setting a return on rate base is that the utility is allowed to
17 recover its interest costs plus a reasonable return on the common equity contributed by its
18 stockholders. After multiplying these costs by the respective proportions of debt and
19 equity, the return on rate base is determined and the return on rate base can be reviewed
20 for sufficient financial coverage.

21 One atypical situation is when a utility has too much equity. If the company and
22 the investors are comfortable with the capitalization there is little reason for the
23 Commission to pursue the utility to undergo recapitalization, other than for the cost

1 impact to ratepayers. An appropriate return methodology for such an atypical situation
2 would be to use a return based on a more typical capital structure. This is what the
3 “capital structure neutral” approach does. Under this approach, the customers would pay
4 a return on rate base no greater than customers of utilities with more typical capital
5 structures. The Commission has used this method in the telecommunications area for
6 companies with atypical high equity levels.

7 **Q. Do you believe that the atypical “capital structure neutral” approach is reasonable**
8 **for a municipal utility’s rate of return?**

9 A. Yes. State statutes give the Commission authority to approve the issuance of securities
10 for investor-owned utilities,¹ but not for municipal utilities. I interpret this difference to
11 mean that the state Legislature gave the governmental entities and their agencies
12 autonomy on this issue. Ms. Lewis’s statement that the manner of financing capital
13 projects is an internal matter to be decided by MWW and the city of Milwaukee would
14 appear to agree with my opinion.

15 The Commission must balance the needs of the utility and its customers. In this
16 context, the municipal utility may prefer more or less debt than is typical, while the
17 customer always wants to pay no more than a reasonable return on equity. The capital
18 structure neutral method provides such balance. Regardless of the capital structure, the
19 ratepayers pay no more than that assumed to be the cost of rate base for a utility with a
20 cost-effective capital structure.

21 **Q. How would imputation of a typical capital structure translate into a formula return**
22 **on rate base?**

¹ Commission authorization for security issuances was removed for telecommunication utilities by 1993 Wisconsin Act 496. The Commission maintains supervisory authority over the capital structure.

1 A. If the Commission assumed a 50 percent debt and 50 percent equity capital structure is
2 cost-effective and that a reasonable cost of equity is equal to the cost of debt plus a
3 4 percent (400 basis points) risk premium, the resulting standard return on rate base
4 formula is the current cost of debt plus 2 percent (200 basis points) used by Commission
5 staff. The use of the debt yield plus 2 percent as a reasonable return on rate base has the
6 same effect as using a hypothetical capital structure of 50 percent equity. Consequently, I
7 believe use of the revenue neutral method complies with the statement that Mr. Rothstein
8 quotes from the AWWA Manual: "Regulatory agencies have imputed a hypothetical
9 capital structure based on an examination of similar companies or industries." (SR2.100
10 to SR2.101)

11 Although the debt plus 2 percent return has been the standard for many years for
12 municipal water and electric rate cases, the basis has not been delineated in Commission
13 rate orders. As far back as 1960, Commission orders for municipal water utilities have
14 referenced what return on rate base was applied, but not the basis for its calculation. The
15 earliest orders show consistent returns across water utilities (with exceptions similar to
16 those granted today for coverage or utility request for less) and do not mention the
17 utility's capitalization. As a result, I will support why a cost of capital for a 50 percent
18 debt/50 percent equity capitalization with a 4 percent cost of debt/equity differential is a
19 reasonable underlying assumption.

20 The Commission in 1994 expressed its opinion on what it considered a reasonable
21 water utility capital structure. In its August 10, 1994, *Findings of Fact, Conclusion of*
22 *Law, and Order Increasing Rates* in docket 3595-WR-100, *Application of the City of*

1 *Mequon, Ozaukee County, as a Water Public Utility, for Authority to Increase Water*
2 *Rates*, the Commission stated:

3 The Commission cautions applicant, however, that a 138.95 percent debt
4 ratio is too high to provide the degree of financial integrity that is required
5 over the long term and recommends that the debt ratio be reduced to
6 reasonable levels as soon as practical. A reasonable municipal capital
7 structure is generally considered to be roughly 50 percent equity and
8 50 percent debt.

9 The appropriate risk differential is always arguable and subjective. On
10 February 16, 1979, Mr. Fred Huebner, the Commission's former Administrator of Utility
11 Accounts and Finance issued the following opinion in a letter:

12 A literal interpretation of section 66.069(1)(e) [now Wis. Stat.
13 § 66.0811(1)] would indicate that the same return on investment allowed
14 investor owned utilities should be allowed to municipal utilities. . . . In
15 determining the return on the equity of the municipality in the utility
16 which would be comparable to common stock equity in investor owned
17 utilities, the commission has again generally taken into consideration the
18 fact that a smaller return is necessary due to the fact that the return to the
19 municipality is an after income tax return whereas to the investor in a
20 private utility, the return is pre-income tax.

21 In rate cases for investor-owned utilities, historic risk premiums of 600 basis
22 points have been argued for returns on equity over comparable public utility bonds. A
23 400 basis point municipal premium reflects a 33 percent reduction for the income tax
24 effect. This reduction is consistent with adjustments I have made when estimating yields
25 for tax-exempt utility bonds issued by investor-owned utilities.

26 **Q. How does the capital neutral method affect a utility with an atypical capital**
27 **structure?**

28 A. As a utility's equity level increases, its average return on municipal equity declines. This
29 conforms to the concept that financial risk declines as equity increases. In addition, since
30 the incremental equity (above 50 percent) earns a return no less than the cost of debt and

1 the average cost of equity remains above the cost of debt, it recognizes that equity has
2 higher risks than debt and should receive a premium above the cost of debt. A utility will
3 earn a constant return on rate base while its return on equity will reflect financial
4 leverage.

5 **Q. Please respond to Mr. Schrader's concerns.**

6 A. One of Mr. Schrader's concerns centers on a potential distribution of \$3 million from
7 water utility revenues for the City's general fund. I understand Mr. Schrader's concerns
8 to be that should any payments to the City's general fund be allowed, the Commission
9 should maintain continued oversight of the utility operations.

10 As referenced in Mr. Wojcehowicz's and Mr. Rothstein's supplemental rebuttal
11 testimony, Wis. Stat. § 66.0811, *Municipal public utility revenues*, governs the
12 distribution of utility income. It states:

13 66.0811(2) The income of a municipal public utility shall first be used to
14 make payments to meet operation, maintenance, depreciation, interest, and
15 debt service fund requirements, local and school tax equivalents, additions
16 and improvements, and other necessary disbursements or indebtedness.
17 Beginning with taxes levied in 1995, payable in 1996, payments for local
18 and school tax equivalents shall at least be equal to the payment made on
19 the property for taxes levied in 1994, payable in 1995, unless a lower
20 payment is authorized by the governing body of the municipality. Income
21 in excess of these requirements may be used to purchase and hold interest
22 bearing bonds, issued for the acquisition of the utility; bonds issued by the
23 United States or any municipal corporation of this state; insurance upon
24 the life of an officer or manager of the utility; or may be paid into the
25 general fund.

26 Consequently, this statute limits the amount that a municipal utility could pay to
27 its municipality. This statute recognizes that MWW's income belongs to the city, not to
28 MWW's customers, but also recognizes the need to ensure the continuing financial health
29 of the utility to protect utility customers and ensure that adequate utility service is
30 provided. MWW may also have distribution restrictions associated with its debt

1 obligations or its charter, but I have not looked at these documents. Lastly, this
2 Commission has ordered additional conditions over distributions from a municipal utility
3 when such additional conditions were in the public interest.² However, I do not believe
4 that any Commission restrictions are warranted at this time.

5 **Q. Please respond to Mr. Wojcehowicz's concerns.**

6 A. Mr. Wojcehowicz was concerned that I did not mention the limitations in Wis. Stat.
7 § 66.0811(2). He believes that the \$3 million distribution should not be made. My
8 supplemental direct testimony was intended to be neutral on the issue of distributions to
9 the city's general funds. Investor-owned utilities regularly pay their investors dividends
10 and even the Wisconsin statutes recognize that a municipal utility can make income
11 distributions to its municipality. Of course, MWW will need to abide by the limitations
12 of Wis. Stat. § 66.0811. In my earlier testimony I did not refer to this statute because my
13 main points were: 1) the income belongs to the owners of MWW, not the customers, and
14 2) whether MWW makes the distribution or not, the return on rate base will be
15 unaffected.

16 **Q. Do you have any additional comments?**

17 A. Yes. I note that with over 90 percent equity, MWW has substantial borrowing capacity
18 for any additions and improvements. If the Commission has concerns about a future
19 income distribution, it could require MWW to provide a 10-year financial forecast
20 showing, at minimum, the forecasted construction expenditures, proposed financing, and
21 proposed capitalization. The filing of the 10-year financial forecast could be required as
22 part of MWW's next rate application³ or could be required within 90 days⁴ of issuance of

² March 12, 2010, *Final Decision* in docket 5-EI-149 Order Point 13 (ERF #128227).

³ This is the usual timing for investor-owned utilities.

1 the order in this case. I believe such a report would better address whether any
2 Commission restrictions are warranted.

3 **Q. Please respond to Mr. Rau's comments.**

4 A. Mr. Rau states that in his supplemental rebuttal testimony (SR2.119 to SR2.120) that
5 when he was discussing how municipal utility borrowing would affect current property
6 owners, he intended "property owner" and "water customer" to be interchangeable, and
7 that my response to his testimony misrepresented him to mean that "property owner" and
8 "taxpayer" were interchangeable. Based on this clarification, I agree that I
9 unintentionally misrepresented his position. Mr. Rau clarified his position, saying that
10 borrowing capital for projects with long lives saves current customers from having to pay
11 all the costs of an asset that will last for 100 years or more. I do not agree with his
12 statement and continue to support the arguments I made in my supplemental direct
13 testimony; that Mr. Rau's statement applies to taxpayers not customers.

14 If a municipal utility uses debt to finance capital improvements it will avoid
15 imposing all the cost of a long-lived asset on the taxpayers, not on customers. Customers
16 are not the owners of these assets and they pay only for the right to use the assets while
17 they are receiving service.

18 **Q. Please continue.**

19 A. To understand my position it is helpful to look at an investor-owned utility, because the
20 positions of customers and investors are more clear. A company is formed and it needs
21 long-lived assets. The company obtains equity investors and issues debt to purchase
22 these assets. As customers are added, the customers must pay for personal upgrades to
23 their own facilities to access the service and may need to pay a contribution in aid of

⁴ Or some other appropriate period.

1 construction (CIAC) related to their service. The amount of debt used to finance the
2 utility assets has no intergenerational impact on the customer. The customer pays a
3 monthly fee for the assets owned by the utility and used for providing the utility service.
4 The customer has no ownership rights to the earned income of the utility; the investor has
5 those rights. It is only through CIAC that one can raise the argument that a customer has
6 provided current payment for a long-lived utility asset, and even that has its caveats.

7 My position that the owners of the municipal utility are the taxpayers is not
8 unique. In his before-referenced February 16, 1979, letter, Mr. Huebner also opined:

9 In response to your particular question expressing concern with the “return
10 on investment” concept where the municipality owns the utility, I would
11 disagree with your statement that the users of the water utility are the
12 stockholders of the utility. As indicated by statute and in my opinion, the
13 citizens of the municipality in their capacity as tax payers are in essence
14 the stockholders of the utility. . . .

15 You will observe, for example, that section 66.069(1)(c) [now Wis. Stat.
16 § 66.0811(2)] provides that the revenue generated by a municipal public
17 utility can and should be used for the same purpose as revenues generated
18 by an investor owned utility including the payment of dividends into the
19 general fund of the municipality for the benefit of property owners as
20 stockholders of the municipal utility.

21 The income of a utility (whether it is restricted or not from distribution to the city
22 at a given point in time) belongs to its owners, the taxpayers. If the utility reinvests its
23 earned income into long-lived assets, it is the taxpayers who have made the investment.
24 The wholesale customers are customers only; they have no investment claim in MWW.
25 They have no claim to any redistribution of income and, because the Commission
26 accounts for atypical capital structures when it establishes the return on rate base, they
27 are unaffected by whether the income or debt is used to finance rate base.

28 **Q. Does this conclude your surrebuttal testimony?**

29 **A.** Yes, it does.